# Fentura Financial, Inc.

Years Ended December 31, 2016 and 2015

Consolidated Financial Statements

# FENTURA FINANCIAL, INC.

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Rehmann

Rehmann Robson

1500 W. Big Beaver Rd.
2nd Floor
Troy, MI 48084
P: 248.952.5000
F: 248.952.5750
rehmann.com

## INDEPENDENT AUDITORS' REPORT

March 23, 2017

Shareholders and Board of Directors
Fentura Financial, Inc.
Fenton, Michigan

We have audited the accompanying consolidated financial statements of ***Fentura Financial, Inc.*** (the "Corporation"), which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, shareholders' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements.

***Management's Responsibility for the Consolidated Financial Statements***

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

***Independent Auditors' Responsibility***

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on auditor judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Corporation's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

***Opinion***

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of ***Fentura Financial, Inc.*** as of December 31, 2016 and 2015, and the consolidated results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

## FENTURA FINANCIAL, INC.

### CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)

| ASSETS | December 31 | |
|---|---|---|
| | 2016 | 2015 |
| Cash and due from banks | $ 59,713 | $ 19,425 |
| Federal funds sold | 18,600 | - |
| **Cash and cash equivalents** | **78,313** | **19,425** |
| Securities, available for sale (AFS) | 68,572 | 23,532 |
| Securities, held to maturity (HTM) | 3,886 | 2,176 |
| **Total securities** | **72,458** | **25,708** |
| Loans held for sale | 3,869 | 2,905 |
| **Loans** | 515,775 | 378,655 |
| Less allowance for loan losses | 2,851 | 3,505 |
| **Net loans** | **512,924** | **375,150** |
| Premises and equipment, net | 12,113 | 9,720 |
| Bank owned life insurance | 9,649 | 6,568 |
| Federal Home Loan Bank ("FHLB") stock | 1,774 | 981 |
| Accrued interest receivable | 1,896 | 1,133 |
| Other real estate owned | 250 | 397 |
| Goodwill | 3,219 | - |
| Core deposit intangibles | 2,526 | - |
| Other assets | 4,359 | 4,415 |
| **Total assets** | **$ 703,350** | **$ 446,402** |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| **Deposits** | | |
| Noninterest-bearing | $ 160,903 | $ 108,102 |
| Interest-bearing | 442,464 | 267,869 |
| **Total deposits** | **603,367** | **375,971** |
| FHLB advances | 30,000 | 20,775 |
| Subordinated debentures | 14,000 | 14,000 |
| Senior debt | 1,000 | - |
| Accrued interest payable and other liabilities | 4,323 | 3,182 |
| **Total liabilities** | **652,690** | **413,928** |
| **Shareholders' equity** | | |
| Common stock, no par value; 5,000,000 shares authorized, 3,619,282 (2,517,748 in 2015) shares issued and outstanding | 58,734 | 43,873 |
| Accumulated deficit | (7,847) | (11,277) |
| Accumulated other comprehensive loss | (227) | (122) |
| **Total shareholders' equity** | **50,660** | **32,474** |
| **Total liabilities and shareholders' equity** | **$ 703,350** | **$ 446,402** |

The accompanying notes are an integral part of these consolidated financial statements.

## FENTURA FINANCIAL, INC.

### CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share data)

| | Year Ended December 31 | |
|---|---|---|
| | 2016 | 2015 |
| **Interest and dividend income** | | |
| Loans, including fees | $ 18,119 | $ 15,983 |
| Investments | | |
| Taxable | 414 | 616 |
| Tax-exempt | 99 | 50 |
| Federal funds sold | 13 | 4 |
| **Total interest and dividend income** | **18,645** | **16,653** |
| **Interest expense** | | |
| Deposits | 1,394 | 1,331 |
| Borrowings | 978 | 822 |
| **Total interest expense** | **2,372** | **2,153** |
| **Net interest income** | 16,273 | 14,500 |
| Provision for loan losses | (900) | (1,000) |
| **Net interest income, after loan losses** | **17,173** | **15,500** |
| **Noninterest income** | | |
| Service charges on deposit accounts | 779 | 806 |
| Net gain on sales of mortgage loans | 3,038 | 2,140 |
| Trust and investment services | 1,367 | 1,255 |
| Net gain on sales of securities | - | 461 |
| Other income and fees | 1,474 | 1,913 |
| **Total noninterest income** | **6,658** | **6,575** |
| **Noninterest expenses** | | |
| Compensation | 9,544 | 8,826 |
| Occupancy | 1,142 | 1,119 |
| Furniture and equipment | 1,192 | 1,143 |
| Loan and collection | 561 | 565 |
| Advertising and promotional | 524 | 413 |
| Telephone and communication | 236 | 146 |
| Acquisition related | 728 | - |
| Other professional services | 1,500 | 1,130 |
| Other general and administrative | 1,670 | 1,634 |
| **Total noninterest expenses** | **17,097** | **14,976** |
| **Income before federal income taxes** | **6,734** | **7,099** |
| Federal income taxes | 2,293 | 2,407 |
| **Net income** | **$ 4,441** | **$ 4,692** |
| **Earnings per share** | **$ 1.70** | **$ 1.87** |

The accompanying notes are an integral part of these consolidated financial statements.

## FENTURA FINANCIAL, INC.

### CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)

| | Year Ended December 31 | |
|---|---|---|
| | 2016 | 2015 |
| **Net income** | **$ 4,441** | **$ 4,692** |
| **Other comprehensive loss** | | |
| **Unrealized (losses) gains on investment securities available for sale** | | |
| Net unrealized holding (losses) gains arising during the year | (110) | 294 |
| Less: Reclassification adjustment for net securities gains included in net income | - | (461) |
| **Change in net unrealized losses before income taxes** | **(110)** | **(167)** |
| **Net losses on cash flow hedge** | | |
| Net unrealized cash flow hedge losses arising during the year | (49) | (207) |
| **Other comprehensive loss before income taxes** | **(159)** | **(374)** |
| Income tax benefit related to other comprehensive loss | **54** | **127** |
| **Other comprehensive loss** | **(105)** | **(247)** |
| **Comprehensive income** | **$ 4,336** | **$ 4,445** |

The accompanying notes are an integral part of these consolidated financial statements.

## FENTURA FINANCIAL, INC.

### CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(In thousands, except share data)

| | Common Stock | Accumulated Deficit | Accumulated Other Comprehensive (Loss) Income | Total |
|---|---|---|---|---|
| **Balances, January 1, 2015** | **$ 43,685** | **$ (15,668)** | **$ 125** | **$ 28,142** |
| Issuance of common shares under stock purchase and dividend reinvestment plans (15,017 shares) | 188 | - | - | 188 |
| Cash dividends paid | - | (301) | - | (301) |
| Comprehensive income | - | 4,692 | (247) | 4,445 |
| **Balances, December 31, 2015** | **43,873** | **(11,277)** | **(122)** | **32,474** |
| Issuance of common shares under stock purchase and dividend reinvestment plans (30,106 shares) | 422 | - | - | 422 |
| Issuance of common shares in private placements, net of issuance costs (1,071,428 shares) | 14,439 | - | - | 14,439 |
| Cash dividends paid | - | (1,011) | - | (1,011) |
| Comprehensive income | - | 4,441 | (105) | 4,336 |
| **Balances, December 31, 2016** | **$ 58,734** | **$ (7,847)** | **$ (227)** | **$ 50,660** |

The accompanying notes are an integral part of these consolidated financial statements.

## FENTURA FINANCIAL, INC.

### CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

| | Year Ended December 31 | |
|---|---|---|
| | 2016 | 2015 |
| **Cash flows from operating activities** | | |
| Net income | $ 4,441 | $ 4,692 |
| Adjustments to reconcile net income to net cash provided by operating activities, net in 2016 of business combination | | |
| Depreciation | 750 | 720 |
| Amortization and accretion on securities, net | (169) | (185) |
| Provision for loan losses | (900) | (1,000) |
| Mortgage loans originated for sale | (101,628) | (86,492) |
| Proceeds from sale of mortgage loans | 103,702 | 86,062 |
| Net gain on sales of mortgage loans | (3,038) | (1,156) |
| Net gain on sales of securities | - | (461) |
| Net gain on sale of other real estate owned | (11) | (79) |
| Deferred income tax expense | 1,296 | 2,186 |
| Net earnings from bank owned life insurance | (217) | (246) |
| Net (increase) decrease in interest receivable and other assets | 401 | (944) |
| Net increase in accrued interest payable and other liabilities | 999 | 482 |
| **Net cash provided by operating activities** | **5,626** | **3,579** |
| **Cash flows from investing activities** | | |
| Proceeds from maturities of securities - HTM | 377 | 391 |
| Proceeds from maturities of securities - AFS | 4,239 | 7,163 |
| Proceeds from calls of securities - HTM | 37 | 402 |
| Proceeds from calls and sales of securities - AFS | 3,020 | 1,551 |
| Purchases of securities - AFS | - | (1,455) |
| Purchase of securities - HTM | (2,124) | (1,314) |
| Origination of loans, net of principal payments | (52,792) | (59,907) |
| Purchases of FHLB stock | (464) | - |
| Proceeds from redemption of FHLB stock | - | 60 |
| Proceeds from sale of other real estate owned | 206 | 2,170 |
| Purchase of premises and equipment | (498) | (630) |
| Acquisition of CSB, net of cash acquired | 21,170 | - |
| **Net cash used in investing activities** | **(26,829)** | **(51,569)** |
| **Cash flows from financing activities** | | |
| Net increase in deposits | 56,016 | 48,048 |
| Cash dividends paid | (1,011) | (301) |
| Net advances on line of credit | 1,000 | - |
| Net (repayments) advances from FHLB | 9,225 | (42) |
| Net proceeds from common stock issuance | 14,861 | 188 |
| **Net cash provided by financing activities** | **80,091** | **47,893** |
| **Net increase (decrease) in cash and cash equivalents** | **58,888** | **(97)** |
| Cash and cash equivalents, beginning of year | 19,425 | 19,522 |
| **Cash and cash equivalents, end of year** | **$ 78,313** | **$ 19,425** |
| **Supplemental cash flows information:** | | |
| Cash paid for interest | $ 2,331 | $ 2,139 |
| Cash paid for income taxes | 169 | - |
| Transfers from loans to other real estate | 98 | - |
| Loans provided for sales of other real estate owned | 162 | 705 |
| **Business combination:** | | |
| Fair value of tangible assets acquired | 144,481 | |
| Goodwill, mortgage servicing rights and core deposit intangible assets acquired | 5,925 | |
| Liabilities assumed | 171,576 | |

The accompanying notes are an integral part of these consolidated financial statements.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Nature of Operations and Principles of Consolidation

The consolidated financial statements include ***Fentura Financial, Inc***. (the Corporation) and its wholly owned subsidiaries Fentura Holdings LLC ("FHLLC") and The State Bank ("the Bank") in Fenton, Michigan. Intercompany transactions and balances are eliminated in consolidation.

The Corporation provides banking and trust services principally to individuals, small businesses and governmental entities through its fifteen community banking offices in Genesee, Livingston, Oakland, Saginaw and Shiawassee Counties in central and southeastern Michigan. Its primary deposit products are checking, savings, and term certificate accounts, and its primary lending products are residential mortgage, commercial, and installment loans. Commercial real estate loans were 47.0% and 47.3% of gross loans, and other commercial loans were 13.3% and 14.5% of gross loans at December 31, 2016 and 2015, respectively. Substantially all loans are secured by specific items of collateral including business assets, consumer assets and real estate. Commercial loans are expected to be repaid from cash flow from operations of businesses. Real estate loans are secured by both residential and commercial real estate. The Corporation's exposure to credit risk is substantially affected by the economy in the Corporation's market area and by changes in commercial real estate values. While the loan portfolio is substantially commercial based, the Corporation is not dependent on any single borrower. Other financial instruments which potentially represent concentrations of credit risk in the normal course of business include deposit accounts in other financial institutions and federal funds sold.

The Bank's primary sources of liquidity are time deposits and non-maturity deposits. At December 31, 2016, retail time deposits equal 9.1% of total deposits. This is compared to December 31, 2015, when retail time deposits consisted of 22.6% of total deposits. Details regarding deposits are further described in Note 9 of the consolidated financial statements.

### Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the consolidated financial statements and the disclosures provided, and future results could differ. The allowance for loan losses, the fair value amounts related to business combinations, the fair values of securities and derivatives, and other financial instruments, other-than-temporary impairment of securities, goodwill and other intangible asset impairment and the carrying value of deferred taxes are particularly subject to change.

### Business Combinations

Pursuant to the guidance of Accounting Standards Codification ("ASC") Topic 805, Business Combinations ("ASC 805"), the Corporation recognizes assets acquired, including identified intangible assets, and the liabilities assumed in acquisitions at their fair values as of the acquisition date, with the acquisition-related transaction costs expensed in the period incurred.

On December 31, 2016, the Corporation acquired all the outstanding stock of Community State Bank of St. Charles, Michigan (“Community State Bank”, or “CSB”) for total cash consideration of approximately $21.6 million. The Corporation recorded approximately $3.2 million of goodwill in conjunction with the merger, which represented the purchase price over the fair value of identifiable net assets acquired. Additionally, the Corporation recorded approximately $2.5 million of identifiable core deposit intangible assets in conjunction with the acquisition related to total deposits acquired of approximately $171.4 million.

ASC 805 affords a measurement period beyond the acquisition date that allows the Corporation the opportunity to finalize the acquisition accounting in the event that new information is identified that existed as of the acquisition date but was not known by the Corporation at that time. The Corporation anticipates that measurement period adjustments may arise from adjustments to the fair values of assets and liabilities recognized at the acquisition date for its December 31, 2016 purchase of Community State Bank, as additional information is obtained, such as appraisals of collateral securing loans and other borrower information. In the event that a measurement period adjustment is identified, the Corporation expects to recognize the adjustment as part of its acquisition accounting, which may result in an adjustment to goodwill being recorded in the period the adjustment is identified.

See Note 2 for further information regarding the Corporation's merger and acquisition activity.

### Basis of Presentation

The cash consideration of $21.6 million paid to acquire Community State Bank was not actually disbursed to the transfer agent until January 4, 2017, though the transaction legally closed effective December 31, 2016. The 2016 financial statements presented herein reflect the effect of this cash transfer as if it had occurred on December 31, 2016. There are no other items recognized in the financial statements associated with 2017 activity.

### Summary of Significant Accounting Policies

#### *Cash and Cash Equivalents*
Cash and cash equivalents (see preceding paragraph), includes cash, deposits with other financial institutions under 90 days, and federal funds sold. Net cash flows are reported for customer loan and deposit transactions and short-term borrowings.

#### *Restrictions on Cash*
Cash on hand or on deposit with the Federal Reserve Bank of $223,000 and $25,000 was required to meet regulatory reserve and clearing requirements at December 31, 2016 and 2015, respectively.

#### *Investment Securities*
Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Securities are classified as available for sale when they might be sold before maturity. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income.

Interest income includes amortization of purchase premiums or discounts. Premiums and discounts on securities are accreted on the level-yield method without anticipating prepayments, except for mortgage-backed securities, where prepayments are anticipated. Premiums are amortized to call date whereby discounts are amortized to maturity. Gains and losses on sales are based on the amortized cost of the security sold.

Management evaluates securities for other-than-temporary impairment ("OTTI") at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation.

In determining OTTI, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Corporation has the intent to sell the debt security or it is more likely than not it will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

When OTTI occurs, the amount of the OTTI recognized in earnings depends on whether the Corporation intends to sell the security or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis, less any current-period credit loss. If the Corporation intends to sell or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis, less any current-period credit loss, the OTTI shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If the Corporation does not intend to sell the security and it is not more likely than not that, the Corporation will not be required to sell the security before recovery of its amortized cost basis less any current-period loss, the OTTI shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected and is recognized in earnings. The amount of the total OTTI related to other factors is recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the OTTI recognized in earnings becomes the new amortized cost basis of the investment.

***Loans Held for Sale***

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value, as determined by outstanding commitments from investors. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings.

Mortgage loans held for sale are generally sold with servicing rights retained. The carrying value of mortgage loans sold is reduced by the amount allocated to the servicing right. Gains and losses on sales of mortgage loans are based on the difference between the selling price and the carrying value of the related loan sold.

***Originated Loans***

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of purchased premiums and discounts, unearned interest, deferred loan fees and costs, and an allowance for loan losses. Loan origination fees, net of certain direct origination costs, are deferred and recognized in interest income using the level-yield method without anticipating prepayments.

Interest income on mortgage and commercial loans is discontinued and placed on non-accrual status at the time the loan is 90 days delinquent unless the loan is well-secured and in the process of collection. Mortgage loans are charged off at 180 days past due and commercial loans are charged off to the extent principal or interest is deemed uncollectible. Consumer and credit card loans continue to accrue interest until they are charged-off no later than 120 days past due unless the loan is in the process of collection. Past-due status is based on the contractual terms of the loan. In all cases, loans are placed on non-accrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. Non-accrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

All interest accrued but not received for loans placed on nonaccrual is reversed against interest income. Interest received on such loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Under the cost-recovery method, interest income is not recognized until the loan balance is reduced to zero. Under the cash-basis method, interest income is recorded when the payment is received in cash. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

***Loans Acquired in a Business Combination***

The Corporation purchases individual loans and groups of loans, some of which have shown evidence of credit deterioration since origination. These purchased credit impaired loans are recorded at the amount paid, such that there is no carryover of the seller's allowance for loan losses. After acquisition, losses are recognized by an increase in the allowance for loan losses.

Such purchased credit impaired loans are accounted for individually or aggregated into pools of loans based on common risk characteristics such as, credit score, loan type, and the date of origination. The Corporation estimates the amount and timing of expected cash flows for each loan or pool, and the expected cash flows in excess of amount paid is recorded as interest income over the remaining life of the loan or pool (accretable yield). The excess of the loan's or pool's contractual principal and interest over expected cash flows is not recorded (nonaccretable difference).

***Allowance for Loan Losses***

The allowance for loan losses is a valuation allowance for probable incurred credit losses, increased by the provision for loan losses and decreased by charge-offs less recoveries. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Consumer loans are typically charged off no later than 120 days past due.

The allowance consists of specific, general, and unallocated components. The specific component relates to loans that are individually classified as impaired or loans otherwise classified as substandard or doubtful. The general component covers non-classified loans and is based on historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segments and is based on the actual weighted average loss history experienced by the Corporation over a range of the most recent 4 quarters to the most recent 20 quarters. This actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. The following portfolio segments have been identified: commercial, commercial real estate, residential real estate, installment loans and home equity loans.

A loan is impaired when full payment under the loan terms is not expected. Commercial and commercial real estate loans are individually evaluated for impairment. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans, are collectively evaluated for impairment, and accordingly, they are not separately identified for impairment disclosures.

***Troubled Debt Restructurings***

Under certain circumstances, the Bank will provide borrowers relief through loan restructurings and modifications. A loan restructuring constitutes a troubled debt restructuring ("TDR") if for economic or legal reasons related to the borrower's financial difficulties the Bank grants a concession to the borrower that it would not otherwise consider. Restructured loans typically present an elevated level of credit risk, as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and are measured for impairment.

***Transfers of Financial Assets***

Transfers of financial assets, including mortgage loans held-for-sale, as described above, are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when 1) the assets have been legally isolated from the Bank, 2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets and 3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity. Other than servicing, the Bank has no substantive continuing involvement related to these loans. The Bank sold residential mortgage loans to an unrelated third party with proceeds of $103,702 and $86,062 during 2016 and 2015, respectively, which resulted in a net gain of $3,038 and $1,156 for 2016 and 2015, respectively. Servicing fee income earned on such loans was $393 and $222 for 2016 and 2015, respectively, and is included in other noninterest income on the consolidated statements of income.

***Derivative Instruments and Hedging Activities***

Derivative instruments are carried at fair value on the consolidated balance sheets and are recorded in either other assets or accrued interest payable and other liabilities. The accounting for changes in the fair value (i.e., gains or losses) of a derivative instrument is determined by whether it has been designated and qualifies as part of a hedging relationship, and, further, by the type of hedging relationship. For derivative instruments that are designated and qualify as cash flow hedges (i.e., hedging the exposure to variability in expected future cash flows that are attributable to a particular risk), the effective portion of the gain or loss on the derivative instrument is reported as a component of other comprehensive income and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. The remaining gain or loss on the derivative instrument in excess of the cumulative change in the present value of future cash flows of the hedged item (i.e. the ineffective portion), if any, is recognized in earnings during the period of change.

For cash flow hedging relationships, the Corporation assesses prospective and retrospective effectiveness as well as measurement based upon the cumulative hypothetical derivative method. Under the hypothetical derivative method, the cumulative change in the fair value of the derivative instrument is compared to the cumulative change in the fair value of a hypothetical derivative. The Corporation uses the cumulative dollar-offset ratio resulting from the application of the hypothetical derivative method to assess effectiveness. In addition, the Corporation assesses whether the hedged forecasted transactions are still probable of occurring, and monitors the creditworthiness of the Counterparty to determine whether the risk of default continues to be remote.

Further information on the Corporation’s derivative instrument and hedging activities is included in Note 10.

***Servicing***

Servicing assets are recognized as separate assets when rights are acquired through the purchase or sale of financial assets. For sales of mortgage loans, a portion of the cost of originating the loan is allocated to the servicing right based on relative fair value. Fair value is based on market prices for comparable mortgage servicing contracts when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses.

Servicing assets or liabilities are amortized in proportion to and over the period of net servicing income or net servicing loss and are assessed for impairment or increased obligation based on fair value of rights compared to amortized cost at each reporting date. Impairment is determined by reviewing the vintage of the loans and comparing the prospective interest rate market to the rate on the current portfolio. Given the recent vintage of the portfolio and the stable to rising rate environment, no impairment has been recorded. Should this situation change, impairment may be evaluated by stratifying rights into tranches based on predominant risk characteristics, such as interest rate, loan category, and investor type. Impairment is recognized through a valuation allowance for an individual tranche, to the extent that fair value is less than the capitalized amount for the tranche. If the Bank later determines that all or a portion of the impairment no longer exists for a particular tranche, a reduction of the allowance may be recorded as an increase to income. The recorded value of mortgage servicing rights was $2,390 and $1,465 as of December 31, 2016 and 2015, respectively. This amount was made up of gross servicing rights of $3,028 and $1,725 and cumulative amortization of $621 and $260, respectively. Loans serviced as of December 31, 2016 and 2015, approximated $211,907 and $128,745, respectively; such loans are not included in the accompanying consolidated balance sheets. The fair value of mortgage servicing rights was estimated to be $2,499 and $1,465 at December 31, 2016 and 2015, respectively. The portfolio was reviewed qualitatively at December 31, 2015 and deemed to have no impairment.

The key economic assumptions used in determining the fair value of mortgage servicing rights at December 31, 2016 are as follows:

| | |
|---|---|
| Annual constant prepayment speed (CPR) | 9.76% |
| Weighted average life (in months) | 288 |
| Discount rate | 9.15% |

| (000s omitted) | 2016 | 2015 |
|---|---|---|
| Mortgage Servicing Rights: | | |
| Beginning of year | $ 1,465 | $ 646 |
| Additions | 1,402 | 1,051 |
| Amortized to expense | (477) | (232) |
| **End of year** | **$ 2,390** | **$ 1,465** |

Servicing fee income is recorded for fees earned for servicing loans for others. The fees are based on a contractual percentage of the outstanding principal, or a fixed amount per loan

and are recognized as income when earned. These fees were $420,000 and $232,000 in 2016 and 2015, respectively. The amortization of mortgage servicing rights is netted against loan servicing fee income, a component of noninterest income.

***Other Real Estate Owned and Foreclosed Assets***
Assets acquired through or instead of loan foreclosure are initially recorded at fair value less estimated selling costs when acquired, establishing a new cost basis. Physical possession of residential real estate property collateralizing a consumer mortgage loan occurs when legal title is obtained upon completion of foreclosure or when the borrower conveys all interest in the property to satisfy the loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. If fair value declines, a valuation allowance is recorded through expense. Costs after acquisition are expensed, as incurred.

***Bank Premises and Equipment***
Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Buildings and related components are depreciated using the straight-line method with useful lives ranging from 15 to 40 years. Furniture, fixtures and equipment are depreciated using the straight-line method with useful lives ranging from 3 to 7 years. Premises and equipment and other assets are reviewed for impairment when events indicate their carrying amount may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at fair value, if lower than the carrying amount.

***Federal Home Loan Bank (FHLB) Stock***
The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income.

***Bank Owned Life Insurance***
The Corporation holds life insurance policies purchased on the lives of key members of management. In the event of death of one of these individuals, the Corporation, as beneficiary of the policies, would receive a specified cash payment equal to the face value of the policy. Such policies are recorded at their cash surrender value, or the amount that can be currently realized as of the balance sheet date. The change in cash surrender value is an adjustment of premiums paid in determining the net expense or income recognized under the contracts for the year and is included in noninterest income.

***Stock Based Compensation***
Compensation cost is recognized for stock options, restricted stock awards issued to employees, and stock appreciation rights based on the fair value of these awards at the date of grant. A valuation model is utilized to estimate the fair value of stock options and stock appreciation rights. Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award.

***Income Taxes***
Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. If determined necessary, a valuation allowance reduces deferred tax assets to the amount expected to be realized.

A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that has a greater than 50% likelihood of being realized on examination including the appeals process. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded.

The Corporation recognizes interest and/or penalties related to income tax matters in income tax expense. Such interest or penalties recorded in 2016 or 2015 were not significant.

***Goodwill and Other Intangible Assets***
Goodwill resulting from business combinations is generally determined as the excess of the fair value of the consideration transferred over the fair value of the net assets acquired and liabilities assumed as of the acquisition date. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized but tested for impairment at least annually or more frequently if events and circumstances exists that indicated that a goodwill impairment test should be performed. The Corporation has selected October 31 as the date to perform the annual impairment test. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. Goodwill is the only intangible asset with an indefinite life on the balance sheet. Core deposit intangible assets arising from whole bank and branch acquisitions are amortized using an accelerated method over their estimated useful lives of 7 years.

***Loan Commitments and Financial Instruments***
Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and standby letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

***Earnings Per Common Share***
Basic earnings per common share is calculated as net income divided by the weighted average number of common shares outstanding during the period. Employee Stock Ownership Plan (ESOP) shares are considered outstanding for this calculation unless unearned.

***Comprehensive Income***
Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains and losses on securities available for sale and cash flow hedges, which are also recognized as separate components of equity.

***Loss Contingencies***
Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated.

***Fair Value of Financial Instruments***
Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 14. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

***Reclassifications***
Certain items in the prior year consolidated financial statements were reclassified to conform to the current year presentation.

***Subsequent Events***
In preparing these consolidated financial statements, the Corporation has evaluated, for potential recognition or disclosure, significant events or transactions that occurred during the period subsequent to December 31, 2016, the most recent balance sheet presented herein, through March 23, 2017, the date these consolidated financial statements were available to be issued. No significant such events or transactions were identified other than as disclosed in the basis of presentation section of this footnote.

***Recent Accounting Pronouncements***
In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers (Topic 606), which will supersede the current revenue recognition requirements in Topic 605, Revenue Recognition. The ASU is based on the principle that revenue is recognized to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The ASU also requires additional disclosure about the nature, amount, timing, and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. The new guidance will be effective for the Corporation's year ending December 31, 2018. The ASU permits application of the new revenue recognition guidance to be applied using one of two retrospective application methods. The Corporation has not yet determined which application method it will use. The Corporation is in the process of evaluating the impact of the new standard on the consolidated financial statements.

In February 2016, the Financial Accounting Standards Board (FASB) issued ASU No. 2016-02, Leases, which will supersede the current lease requirements in ASC 840. The ASU requires lessees to recognize a right-of-use asset and related lease liability for all leases, with a limited exception for short-term leases. Leases will be classified as either finance or operating, with the classification affecting the pattern of expense recognition in the statement of operations. Currently, leases are classified as either capital or operating, with only capital leases recognized on the balance sheet. The reporting of lease-related expenses in the statements of operations and cash flows will be generally consistent with the current guidance. The new lease guidance will be effective for the Corporation's year ending December 31, 2019 and will be applied using a modified retrospective transition method to the beginning of the earliest period presented. The new lease standard is not expected to have a significant effect on the Corporation’s consolidated financial statements as a result of the leases classified as operating leases.

In June 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-13, Financial Instruments - Credit Losses: Measurement of Credit Losses on Financial Instruments. The ASU includes increased disclosures and various changes to the accounting and measurement of financial assets including the Corporation's loans and available-for-sale and held-to-maturity debt securities. Each financial asset presented on the consolidated balance sheet would have a unique allowance for credit losses valuation account that is deducted from the amortized cost basis to present the net carrying value at the amount expected to be collected on the financial asset. The amendments in this ASU also eliminate the probable initial recognition threshold in current GAAP and instead, reflect an entity's current estimate of all expected credit losses using reasonable and supportable forecasts. The new credit loss guidance will be effective for the Corporation's year ending December 31, 2021. Upon adoption, the ASU will be applied using a modified retrospective transition method to the beginning of the first reporting period in which the guidance is effective. A prospective transition approach is required for debt securities for which an other-than-temporary impairment had been recognized before the effective date. Existing purchased credit impaired (PCI) assets will be grandfathered and classified as purchased credit deteriorated (PCD) assets at the date of adoption. The asset will be grossed up for the allowance for expected credit losses for all PCD assets at the date of the adoption and will continue to recognize the non-credit discount in interest income based on the yield of such assets as of the adoption date. Subsequent changes in expected credit losses will be recorded through the allowance. For all other assets within the scope of the standard, a cumulative-effect adjustment will be recognized in retained earnings as of the beginning of the first reporting period in which the guidance is effective. Early adoption for all institutions is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Corporation is still quantifying the impact of the new standard.

## 2. ACQUISITION

***Acquisition of Community State Bank***

On March 23, 2016, the Corporation entered into an Agreement and Plan of Merger with Community Bancorp, Inc. and its wholly owned subsidiary Community State Bank, to acquire 100% of the seller's outstanding common stock in a cash transaction. The effective closing date was December 31, 2016. The Corporation believes that the combination will benefit combined customers, employees, and communities for years to come. The transaction is expected to also enhance the value to shareholders, as the acquisition is expected to be immediately accretive to earnings per share. Total cash consideration paid for the purchase of Community State Bank was approximately $21.6 million. In addition, the Corporation incurred $728,000 of acquisition-related transaction expenses for the year ended December 31, 2016 related to the purchase of Community State Bank. As a result of the acquisition, Community State Bank was merged into The State Bank, a wholly owned subsidiary of the Corporation.

The Corporation determined that the purchase of Community State Bank constitutes a business combination as defined by ASC 805. Accordingly, the assets acquired and liabilities assumed were recorded at their fair values on the date of acquisition. Fair values were determined in accordance with the guidance provided in ASC Topic 820, Fair Value Measurements. In many cases the determination of the fair values required management to make estimates about discount rates, future expected cash flows, market conditions and other future events that are highly subjective in nature and subject to change. The following allocation is based on the information that was available to make preliminary estimates of the fair value and may change as additional information becomes available and additional analyses are completed. While the Corporation believes that information provided a reasonable basis for estimating the fair values, it expects that it could obtain additional information and evidence during the measurement period that may result in changes to the estimated fair value amounts. This measurement period ends on the earlier of one year after the merger date or the date the Corporation receives the information about the facts and circumstances that existed at the merger date. Subsequent adjustments are, and if necessary, will be reflected in future financial statements. These refinements include: (1) changes in the estimated fair value of loans acquired, (2) changes in the estimated fair value of intangible assets acquired, (3) changes in deferred taxes related to fair value estimates and (4) a residual change in the goodwill caused by the net effect of these adjustments.

The following table summarizes the consideration paid for Community State Bank and the amounts of the assets acquired and liabilities assumed recognized at the acquisition date, as well as the fair value at the acquisition date (000s omitted):

| | |
|---|---|
| **Cash consideration paid** | **$ 21,630** |
| | |
| **Fair value of identifiable assets acquired:** | |
| Cash and cash equivalents | 24,200 |
| Federal funds sold | 18,600 |
| Investments – available for sale | 52,662 |
| Loans – net | 84,071 |
| Premises and equipment, net | 2,645 |
| Bank owned life insurance | 2,864 |
| Accrued interest receivable | 544 |
| Other real estate owned | 112 |
| Core deposit intangible | 2,526 |
| Other assets | 1,763 |
| **Total identifiable assets acquired** | **$ 189,987** |
| | |
| **Fair value of liabilities assumed:** | |
| Deposits | (171,380) |
| Accrued interest payable and other liabilities | (196) |
| **Total liabilities assumed** | **$ 171,576** |
| | |
| **Fair value of net identifiable assets acquired** | **$ 18,411** |
| **Goodwill resulting from acquisition** | **$ 3,219** |

### Unaudited Pro Forma Combined Results of Operations

The following table presents pro forma financial information for 2016 as if the acquisition had occurred at the beginning of 2016. The pro forma information includes adjustments for certain purchase accounting fair value adjustments, amortization of intangibles arising from the transaction, depreciation expense on property acquired and the related income tax effects. The pro forma financial information is not necessarily indicative of the results of operations that would have occurred had the transaction been effected on the assumed date of January 1, 2016. In particular, no adjustments have been made to eliminate the amount of Community State Bank's provision for loan losses incurred prior to the acquisition date that would not have been necessary had the acquired loans been recorded at their fair value as of the beginning of 2016.

| | Pro Forma 2016<br>(000's omitted except per share data) |
|---|---|
| Net interest income | $22,622 |
| Net income | 5,363 |
| Basic earnings per share | 2.06 |

## 3. GOODWILL AND INTANGIBLE ASSETS

The Corporation has goodwill and core deposit intangible assets which arose as a result of business combinations. Amortization is recorded on the core deposit intangible assets.

Goodwill recorded is primarily attributable to the synergies and economies of scale expected from combining the operations of the Corporation and other acquisitions. The Corporation recorded goodwill in the amount of approximately $3.2 million related to the purchase of Community State Bank completed on December 31, 2016. Goodwill is not amortized but is evaluated at least annually for impairment.

The core deposit intangible asset of approximately $2.5 million at December 31, 2016 is being amortized over a 7 year period on an accelerated basis. The core deposit intangible is analyzed quarterly for impairment.

The estimated future amortization expense on the core deposit intangible asset for years ending December 31 are as follows (000's omitted):

| | |
|---|---|
| 2017 | $ 632 |
| 2018 | 541 |
| 2019 | 451 |
| 2020 | 361 |
| 2021 | 271 |
| Thereafter | 270 |
| Total | $ 2,526 |

## 4. EARNINGS PER SHARE

The components in the earnings per share computation follow:

| (000s omitted except share and per share data) | 2016 | 2015 |
|---|---|---|
| **Basic** | | |
| Net income | $ 4,441 | $ 4,692 |
| Weighted average common shares outstanding | 2,608,903 | 2,511,817 |
| **Basic earnings per common share** | **$ 1.70** | **$ 1.87** |

There were no common stock options or other common stock equivalents outstanding at December 31, 2016 or December 31, 2015 respectively.

## 5. INVESTMENT SECURITIES

Year-end securities were as follows:

| 2016 (000s omitted) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| **Available for sale** | | | | |
| U.S. government and federal agency | $ 37,414 | $ - | $ - | $ 37,414 |
| State and municipal | 15,945 | 10 | (32) | 15,923 |
| Mortgage backed residential | 6,194 | 92 | (16) | 6,270 |
| Certificates of deposits | 4,460 | - | - | 4,460 |
| Collateralized mortgage obligations – agencies | 3,177 | 19 | (2) | 3,194 |
| Equity | 1,256 | 72 | (17) | 1,311 |
| | $ 68,446 | $ 193 | $ (67) | $ 68,572 |
| **Held to Maturity** | | | | |
| State and municipal | $ 3,886 | $ 1 | $ (85) | $ 3,802 |

| 2015 (000s omitted) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| **Available for sale** | | | | |
| U.S. government and federal agency | $ 2,995 | $ - | $ (12) | $ 2,983 |
| State and municipal | 5,736 | 13 | (66) | 5,683 |
| Mortgage backed residential | 7,775 | 129 | (10) | 7,894 |
| Collateralized mortgage obligations – agencies | 5,534 | 38 | (9) | 5,563 |
| Equity | 1,256 | 156 | (3) | 1,409 |
| | $ 23,296 | $ 336 | $ (100) | $ 23,532 |
| **Held to Maturity** | | | | |
| State and municipal | $ 2,176 | $ 6 | $ - | $ 2,182 |

Contractual maturities of securities at December 31, 2016, were as follows. Securities not due at a single maturity date, collateralized mortgage obligations and equity securities are shown separately.

| 2016 (000s omitted) | Available for Sale | | Held to Maturity | |
|---|---|---|---|---|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| U.S. government and federal agency | | | | |
| Due from one year or less | $ 14,272 | $ 14,272 | $ - | $ - |
| Due from one to five years | 23,142 | 23,142 | - | - |
| State and Municipal | | | | |
| Due in one year or less | 5,833 | 5,833 | 211 | 212 |
| Due from one to five years | 9,515 | 9,512 | 1,922 | 1,905 |
| Due from five to ten years | 597 | 578 | 1,373 | 1,322 |
| Due after ten years | - | - | 380 | 363 |
| State and Municipal | | | | |
| Due in one year or less | - | - | - | - |
| Due from one to five years | 4,458 | 4,458 | - | - |
| Due from five to ten years | 2 | 2 | - | - |
| Mortgage backed residential | 6,194 | 6,270 | - | - |
| Collateralized mortgage obligations – agencies | 3,177 | 3,194 | - | - |
| Equity | 1,256 | 1,311 | - | - |
| | $ 68,446 | $ 68,572 | $ 3,886 | $ 3,802 |

Securities pledged at December 31, 2016 and 2015 had a carrying amount of $6,839 and $13,232, respectively, and were pledged to secure public deposits and borrowings.

Securities with unrealized losses at December 31, 2016 and 2015, including both available for sale and held to maturity securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position are as follows:

| 2016 (000s omitted) | Less Than 12 Months | | Over 12 Months | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Gross Unrealized Loss | Fair Value | Gross Unrealized Loss | Fair Value | Total Gross Unrealized Losses |
| U.S. government and federal agency | $ - | $ - | $ - | $ - | $ - | $ - |
| State and municipal | 5,800 | (96) | 479 | (21) | 6,279 | (117) |
| Mortgage backed residential | 2,146 | (16) | - | - | 2,146 | (16) |
| Certificates of deposit | - | - | - | - | - | - |
| Collateralized mortgage obligations - agencies | 490 | (2) | - | - | 490 | (2) |
| Equity securities | 986 | (14) | 3 | (3) | 989 | (17) |
| **Total** | $ 9,422 | $ (128) | $ 482 | $ (24) | $ 9,904 | $ (152) |

| 2015 (000s omitted) | Less Than 12 Months | | Over 12 Months | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Gross Unrealized Loss | Fair Value | Gross Unrealized Loss | Fair Value | Total Gross Unrealized Losses |
| U.S. government and federal agency | $ 2,983 | $ (12) | $ - | $ - | $ 2,983 | $ (12) |
| State and municipal | 2,871 | (54) | 738 | (12) | 3,609 | (66) |
| Mortgage backed residential | - | - | 2,490 | (10) | 2,490 | (10) |
| Collateralized mortgage obligations - agencies | 1,103 | (9) | - | - | 1,103 | (9) |
| Equity | - | - | 3 | (3) | 3 | (3) |
| **Total** | $ 6,957 | $ (75) | $ 3,231 | $ (25) | $ 10,188 | $ (100) |

As of December 31, 2016 , the Corporation's security portfolio consisted of 182 securities, 51 of which were in an unrealized loss position.

Management evaluates securities for other-than-temporary impairment ("OTTI") at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. In evaluating OTTI, management additionally considers the factors presented in Note 1. No OTTI was indicated following analysis in 2016 and 2015.

## 6. LOANS AND ALLOWANCE FOR LOAN LOSSES

The Bank originates primarily residential and commercial real estate loans, commercial, and installment loans. The Corporation estimates that the majority of the Bank's loan portfolio is based in Genesee, Oakland, Saginaw, Shiawassee and Livingston counties within central and southeast Michigan. The ability of the Corporation's debtors to honor their contracts is dependent upon the real estate and general economic conditions in these areas.

Loans are summarized as follows at December 31:

| (000s omitted) | 2016 | 2015 |
|---|---|---|
| Commercial | $ 66,912 | $ 54,783 |
| Commercial real estate | 235,893 | 178,938 |
| Residential real estate | 179,340 | 115,351 |
| Home equity | 30,917 | 26,716 |
| Installment | 6,985 | 2,290 |
| Total loans | 520,047 | 378,078 |
| Allowance for loan losses | (2,851) | (3,505) |
| Unamortized premium/discount on purchased loans | (5,234) | - |
| Net deferred loan fees | 962 | 577 |
| **Loans, net** | **$ 512,924** | **$ 375,150** |

Activity in the allowance for loan losses, by loan portfolio segment, for the year ended December 31, 2016, is as follows:

| (000s omitted) | Commercial | Commercial Real Estate | Residential Real Estate | Installment | Home Equity | Unallocated | Total |
|---|---|---|---|---|---|---|---|
| Balance, January 1, 2016 | $ 229 | $ 1,843 | $ 590 | $ 41 | $ 110 | $ 692 | $ 3,505 |
| Provision for loan losses | 7 | (469) | 230 | (19) | 56 | (705) | (900) |
| Loans charged off | - | (8) | - | (3) | - | - | (11) |
| Loan recoveries | - | 138 | 102 | 9 | 8 | - | 257 |
| **Balance, December 31, 2016** | **$ 236** | **$ 1,504** | **$ 922** | **$ 28** | **$ 174** | **$ (13)** | **$ 2,851** |

Activity in the allowance for loan losses, by loan portfolio segment, for the year ended December 31, 2015, is as follows:

| (000s omitted) | Commercial | Commercial Real Estate | Residential Real Estate | Installment | Home Equity | Unallocated | Total |
|---|---|---|---|---|---|---|---|
| Balance, January 1, 2015 | $ 356 | $ 2,762 | $ 636 | $ 45 | $ 152 | $ 455 | $ 4,406 |
| Provision for loan losses | (217) | (943) | (13) | 18 | (82) | 237 | (1,000) |
| Loans charged off | - | (146) | (33) | (27) | - | - | (206) |
| Loan recoveries | 90 | 170 | - | 5 | 40 | - | 305 |
| **Balance, December 31, 2015** | **$ 229** | **$ 1,843** | **$ 590** | **$ 41** | **$ 110** | **$ 692** | **$ 3,505** |

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by loan portfolio segment, and impairment evaluation method at December 31, 2016:

| (000s omitted) | Commercial | Commercial Real Estate | Residential Real Estate | Installment | Home Equity | Unallocated | Total |
|---|---|---|---|---|---|---|---|
| **Ending allowance balance attributable to loans** | | | | | | | |
| Individually evaluated for impairment | $ 4 | $ 234 | $ 59 | $ - | $ - | $ - | $ 297 |
| Collectively evaluated for impairment | 232 | 1,270 | 863 | 28 | 174 | (13) | 2,554 |
| **Total ending allowance balance** | **$ 236** | **$ 1,504** | **$ 922** | **$ 28** | **$ 174** | **$ (13)** | **$ 2,851** |

| (000s omitted) | Commercial | Commercial Real Estate | Residential Real Estate | Installment | Home Equity | Unallocated | Total |
|---|---|---|---|---|---|---|---|
| **Loans** | | | | | | | |
| Loans individually evaluated for impairment | $ 28 | $ 3,134 | $ 253 | $ - | $ 32 | | $ 3,447 |
| Loans collectively evaluated for impairment | 64,765 | 227,748 | 176,259 | 2,349 | 35,188 | | 506,309 |
| Acquired with deteriorated credit quality | 1,150 | 2,501 | 2,241 | 22 | 105 | | 6,019 |
| Total ending loan balance | 65,943 | 233,383 | 178,753 | 2,371 | 35,325 | | 515,775 |
| Accrued interest receivable | 197 | 627 | 348 | 32 | 127 | | 1,331 |
| **Total recorded Investment in loans** | **$ 66,140** | **$ 234,010** | **$ 179,101** | **$ 2,403** | **$ 35,452** | | **$ 517,106** |

The following tables present the balance in the allowance for loan losses and the recorded investment in loans by loan portfolio segment and based on impairment method at December 31, 2015:

| (000s omitted) | Commercial | Commercial Real Estate | Residential Real Estate | Installment | Home Equity | Unallocated | Total |
|---|---|---|---|---|---|---|---|
| **Ending allowance balance attributable to loans** | | | | | | | |
| Individually evaluated for impairment | $ 27 | $ 116 | $ 64 | $ - | $ 6 | $ - | $ 213 |
| Collectively evaluated for impairment | 202 | 1,727 | 526 | 41 | 104 | 692 | 3,292 |
| **Total ending allowance balance** | **$ 229** | **$ 1,843** | **$ 590** | **$ 41** | **$ 110** | **$ 692** | **$ 3,505** |
| **Loans** | | | | | | | |
| Loans individually evaluated for impairment | $ 81 | $ 3,773 | $ 345 | $ - | $ 27 | | $ 4,226 |
| Loans collectively evaluated for impairment | 54,859 | 175,140 | 115,443 | 2,298 | 26,689 | | 374,429 |
| Total ending loan balance | 54,940 | 178,913 | 115,788 | 2,298 | 26,716 | | 378,655 |
| Accrued interest receivable | 162 | 439 | 313 | 7 | 97 | | 1,018 |
| **Total recorded Investment in loans** | **$ 55,102** | **$ 179,352** | **$ 116,101** | **$ 2,305** | **$ 26,813** | | **$ 379,673** |

The Corporation has purchased loans, for which there was, at acquisition, evidence of deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected. Information regarding purchased credit impaired loans as of the acquisition date of December 31, 2016 is as follows (000's omitted):

| | |
|---|---|
| Contractual cash flows | $ 8,908 |
| Contractual cash flows not expected to be collected (nonaccretable difference) | 1,448 |
| Expected cash flows | 7,460 |
| Interest component of expected cash flows (accretable yield) | 1,441 |
| Fair value at acquisition | $ 6,019 |

At December 31, 2016, the outstanding contractual principal balance and the carrying amount of the acquired loan portfolio were $89,303 and $84,071, respectively.

As purchase credit impaired loans were acquired on December 31, 2016 there is no associated allowance as of year-end or accretion recorded in the 2016 statement of income.

The following table presents originated loans individually evaluated for impairment by portfolio class of loans as of December 31, 2016:

| (000s omitted) | Unpaid Principal Balance | Recorded Investment | Allowance For Loan Losses Allocated | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| **With no related allowances recorded** | | | | | |
| Commercial | $ - | $ - | $ - | $ 9 | $ - |
| Commercial real estate | 1,766 | 1,353 | - | 1,003 | 75 |
| Residential real estate | - | - | - | 28 | 4 |
| Consumer | | | | | |
| Installment loans | - | - | - | - | - |
| Home equity | 32 | 32 | - | 7 | 1 |
| **With an allowance recorded** | | | | | |
| Commercial | 41 | 26 | 4 | 88 | 5 |
| Commercial real estate | 1,786 | 1,790 | 234 | 3,508 | 84 |
| Residential real estate | 253 | 254 | 59 | 384 | 11 |
| Consumer | | | | | |
| Installment loans | - | - | - | - | - |
| Home equity | - | - | - | 23 | - |
| **Total** | $ 3,878 | $ 3,455 | $ 297 | $ 5,050 | $ 180 |

The following table presents loans individually evaluated for impairment by portfolio class of loans as of December 31, 2015:

| (000s omitted) | Unpaid Principal Balance | Recorded Investment | Allowance For Loan Losses Allocated | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| **With no related allowances recorded** | | | | | |
| Commercial | $ 102 | $ - | $ - | $ 9 | $ 7 |
| Commercial real estate | 2,346 | 1,600 | - | 1,220 | 139 |
| Residential real estate | 33 | - | - | 28 | 6 |
| Consumer | | | | | |
| Installment loans | - | - | - | - | - |
| Home equity | - | - | - | 41 | 1 |
| **With an allowance recorded** | | | | | |
| Commercial | 93 | 81 | 27 | 99 | 2 |
| Commercial real estate | 2,072 | 2,072 | 116 | 3,625 | 108 |
| Residential real estate | 345 | 345 | 64 | 403 | 15 |
| Consumer | | | | | |
| Installment loans | - | - | - | - | - |
| Home equity | 27 | 27 | 6 | 28 | 2 |
| **Total** | $ 5,018 | $ 4,125 | $ 213 | $ 5,453 | $ 280 |

Non-accrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

The Corporation did not have any originated non-accrual or past due loans at December 31, 2016.

The following table presents the recorded investment in nonaccrual loans and those greater than 90 days past due and still accruing interest by class of loans as of December 31, 2015:

| (000s omitted) | Nonaccrual | Past Due greater than 90 days and still accruing |
|---|---|---|
| Commercial | $ 25 | $ 46 |
| Commercial real estate | 201 | 141 |
| Home equity | - | - |
| Installment loans | - | - |
| Residential real estate | - | - |
| **Total** | **$ 226** | **$ 187** |

The following table presents the aging of the recorded investment in past due originated loans by class of loans as of December 31, 2015:

| (000s omitted) | 30-59 Days Past Due | 60-89 Days Past Due | Greater than 90 Days Past Due | Total Past Due |
|---|---|---|---|---|
| Commercial | $ - | $ - | $ 25 | $ 25 |
| Commercial real estate | - | - | 201 | 201 |
| Installment loans | - | - | - | - |
| Residential real estate | - | - | - | - |
| **Total** | **$ -** | **$ -** | **$ 226** | **$ 226** |

**Modifications**

A modification of a loan constitutes a troubled debt restructuring ("TDR") when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Corporation offers various types of concessions when modifying a loan or lease, however, forgiveness of principal is rarely granted. Commercial loans modified in a TDR often involve temporary interest-only payments, term extensions, and converting revolving credit lines to term loans. Additional collateral, a co-borrower, or a guarantor is often requested. Commercial real estate loans modified in a TDR often involve reducing the interest rate for the remaining term of the loan, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk, or substituting or adding a new borrower or guarantor. Residential real estate loans modified in a TDR are primarily comprised of loans where monthly payments are lowered to accommodate the borrowers' financial needs through a reduction of interest rate and/or extension of the maturity date. Installment loans modified in a TDR are primarily comprised of loans where the Corporation has lowered monthly payments by extending the term.

Loans modified in a TDR are typically already on nonaccrual status and partial charge-offs have in some cases been taken against the outstanding loan balance. As a result, loans

modified in a TDR for the Corporation may have the financial effect of increasing the specific allowance associated with the loan.

The Corporation allocated $283 and $201 of specific reserves to customers whose loan terms have been modified in TDRs as of December 31, 2016 and 2015, respectively. The Corporation does not have material commitments to lend additional funds to borrowers with loans whose terms have been modified in troubled debt restructurings or whose loans are on nonaccrual as of December 31, 2015.

There were no loans modified in a TDR during 2016 or 2015. There were no TDRs that defaulted in 2016 or 2015.

Based on the Corporation's historical loss experience, losses associated with TDRs are not significantly different than other impaired loans within the same loan segment. As such, TDRs are analyzed in the same manner as other impaired loans within their respective loan segment.

**Credit Quality Indicators**
The Corporation categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debts such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Corporation analyzes loans individually by classifying the loans as to credit risk. This analysis includes non-homogeneous loans, such as commercial and commercial real estate loans. This analysis is performed on a quarterly basis. The Corporation uses the following definitions for classified risk ratings:

**Prime.** Loans classified as prime are well seasoned borrowers displaying strong financial condition, consistently superior earnings performance, and access to a range of financing alternatives. The borrower's trends and outlook, as well as those of its industry, are positive.

**Pass.** Loans classified as pass have a moderate to average risk to established borrowers that display sound financial condition and operating results. The capacity to service debt is stable and demonstrated at a level consistent with or above the industry norms. Borrower and industry trends and outlook are considered good.

**Watch.** Loans classified as watch have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

**Substandard.** Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

**Doubtful.** Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The Corporation does not typically classify loans as doubtful. Loans that approach this status are charged-off.

Based on the most recent analysis performed, the ending loan balance by risk category of loans by portfolio class is as follows at December 31:

| 2016 (000s omitted) | Prime | Pass | Watch | Substandard | Total |
|---|---|---|---|---|---|
| **Originated Loans** | | | | | |
| Commercial | $ 49,472 | $ 414 | $ 38 | $ 144 | $ 50,068 |
| Commercial real estate | 198,396 | 6,533 | 498 | 129 | 205,556 |
| **Total** | $ 247,868 | $ 6,947 | $ 536 | $ 273 | $ 255,624 |
| **Acquired Loans** | | | | | |
| Commercial | $ 11,380 | $ 2,926 | $ 1,111 | $ 458 | $ 15,875 |
| Commercial real estate | 19,928 | 5,251 | 1,613 | 1,035 | 27,827 |
| **Total** | $ 31,308 | $ 8,177 | $ 2,724 | $ 1,493 | $ 43,702 |

| 2015 (000s omitted) | Prime | Pass | Watch | Substandard | Total |
|---|---|---|---|---|---|
| Commercial | $ 54,554 | $ 403 | $ 103 | $ 42 | $ 55,102 |
| Commercial real estate | 171,314 | 6,190 | 1,542 | 306 | 179,352 |
| **Total** | $ 225,868 | $ 6,593 | $ 1,645 | $ 348 | $ 234,454 |

The Corporation considers the performance of the loan portfolio and its impact on the allowance for loan losses. For residential and consumer loan classes, the Corporation also evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following table presents the ending loan balance in residential and consumer loans based on payment activity as of December 31, 2016 and 2015:

| 2016 (000s omitted) | Home Equity | Installment | Residential Real Estate | Total |
|---|---|---|---|---|
| **Originated Loans** | | | | |
| Performing | $ 30,916 | $ 1,826 | $ 143,338 | $ 176,080 |
| Non-performing | - | - | - | - |
| **Total** | $ 30,916 | $ 1,826 | $ 143,338 | $ 176,080 |
| **Acquired Loans** | | | | |
| Performing | $ 4,409 | $ 545 | $ 35,415 | $ 40,369 |
| Non-performing | - | - | - | - |
| **Total** | $ 4,409 | $ 545 | $ 35,415 | $ 40,369 |

| 2015 (000s omitted) | Home Equity | Installment | Residential Real Estate | Total |
|---|---|---|---|---|
| Performing | $ 26,813 | $ 2,305 | $ 116,101 | $ 145,219 |
| Non-performing | - | - | - | - |
| **Total** | **$ 26,813** | **$ 2,305** | **$ 116,101** | **$ 145,219** |

Loans to principal officers, directors, and affiliates at December 31, 2016 and 2015 were $5,562 and $5,372, respectively.

## 7. OTHER REAL ESTATE OWNED

Activity in other real estate owned for the years ended December 31 was:

| (000s omitted) | 2016 | 2015 |
|---|---|---|
| Beginning balance, January 1 | $ 397 | $ 2,488 |
| Transfers into other real estate | 98 | - |
| ORE acquired in acquisition | 112 | |
| Sales of other real estate owned | (357) | (2,091) |
| Provision for other real estate owned losses | - | - |
| **Ending balance** | **$ 250** | **$ 397** |

At December 31, 2016, the balance of real estate owned consists entirely of foreclosed residential real estate properties recorded as a result of obtaining physical possession of the property. At December 31, 2016, there is no recorded investment of consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceeds are in process.

Net gains on sales of other real estate owned were $11 in 2016 and $79 in 2015. Carrying costs associated with other real estate owned totaled $79 in 2016 and $124 in 2015.

## 8. PREMISES AND EQUIPMENT, NET

Bank premises and equipment, net, is comprised of the following at December 31:

| (000s omitted) | 2016 | 2015 |
|---|---|---|
| Land and land improvements | $ 2,954 | $ 2,493 |
| Building and building improvements | 15,875 | 11,299 |
| Furniture and equipment | 8,604 | 4,846 |
| Construction in progress | - | 380 |
| | 27,433 | 19,018 |
| Less accumulated depreciation | 15,320 | 9,298 |
| **Ending balance** | **$ 12,113** | **$ 9,720** |

Depreciation expense was $750 and $720 for 2016 and 2015, respectively.

The Corporation leases property for certain branches and ATM locations. Rent expense was approximately $76 and $60 for 2016 and 2015, respectively. Rent commitments under non-cancelable operating leases were as follows, before considering renewal options that generally are present at December 31, 2016 (000s omitted):

| | |
|---|---|
| 2018 | $ 66 |
| 2019 | 66 |
| 2020 | 67 |
| 2021 | 41 |
| 2022 | 12 |
| | $ 252 |

## 9. DEPOSITS

The following is a summary of deposits at December 31:

| (000s omitted) | 2016 | 2015 |
|---|---|---|
| **Non-interest bearing** | | |
| Demand | $ 160,903 | $ 108,102 |
| **Interest-bearing** | | |
| Savings | 213,499 | 102,718 |
| Money market demand | 107,160 | 67,614 |
| Time, $100,000 and over | 46,252 | 38,563 |
| Time, $100,000 and under | 75,553 | 58,974 |
| Total interest bearing | 442,464 | 267,869 |
| **Total deposits** | **$ 603,367** | **$ 375,971** |

Scheduled maturities of time deposits for years succeeding December 31, 2016, were as follows (000s omitted):

| | |
|---|---|
| 2017 | $ 57,818 |
| 2018 | 29,738 |
| 2019 | 19,680 |
| 2020 | 8,928 |
| 2021 | 5,309 |
| Thereafter | 332 |
| | **$ 121,805** |

The Corporation held $10,109 in brokered deposits at December 31, 2016 and 2015.

Deposits from principal officers, directors, and affiliates at December 31, 2016 and 2015 were $5,671 and $5,658, respectively.

## 10. BORROWINGS

**Federal Home Loan Bank Advance**

At year-end, advances from the FHLB were as follows:

| Principal Term (000s omitted) | Advance Amount | Maturity Date |
|---|---|---|
| December 31, 2016 | | |
| Fixed rate advance With rate of 1.19% | 5,000 | October 2017 |
| Fixed rate advance With rate of 1.66% | 10,000 | November 2018 |
| Fixed rate advance With rate of 1.84% | 5,000 | October 2019 |
| One-time putable advance With rate of 1.06%, putable 2/23/21 | 10,000 | February 2026 |
| | $ 30,000 | |
| December 31, 2015 | | |
| Fixed rate advance With rate of 7.34% | $ 775 | May 2016 |
| Fixed rate advance With rate of 1.19% | 5,000 | October 2017 |
| Fixed rate advance With rate of 1.66% | 10,000 | November 2018 |
| Fixed rate advance With rate of 1.84% | 5,000 | October 2019 |
| | $ 20,775 | |

The advances are payable at their maturity date; a prepayment penalty is assessed with early payoffs of advances. The advances are collateralized by securities totaling $6,320 and loans totaling $117,386 at December 31, 2016 and securities totaling $13,232 and loans totaling $72,960 at December 31, 2015.

Maturities over each of the next five years are (000s omitted):

| | |
|---|---|
| 2017 | $ 5,000 |
| 2018 | 10,000 |
| 2019 | 5,000 |
| 2020 | - |
| 2021 and thereafter | 10,000 |
| | $ 30,000 |

**Subordinated Debentures and Trust Preferred Securities**
A trust formed by the Corporation issued $12,000 of trust preferred securities in 2003 as part of a pooled offering of such securities. The interest rate is a floating rate (3 month LIBOR plus 3.00%), and the current rate at December 31, 2016 is 3.34%. The Corporation issued subordinated debentures at the same terms as the trust preferred securities to the trust in exchange for the proceeds of the offering; the debentures and related debt issuance costs represent the sole assets of the trust. The Corporation may redeem the subordinated debentures, in whole but not in part, any time after 2008 at a price of 100% of face value. The subordinated debentures must be redeemed no later than 2033.

A trust formed by the Corporation issued $2,000 of trust preferred securities in 2005 as part of a pooled offering of such securities. The interest rate is a floating rate (3 month LIBOR plus 1.60%), and the current rate at December 31, 2016 is 2.52%. The Corporation issued subordinated debentures at the same terms as the trust preferred securities to the trust in exchange for the proceeds of the offering; the debentures and related debt issuance costs represent the sole assets of the trust. The Corporation may redeem the subordinated debentures, in whole but not in part, any time after 2010 at a price of 100% of face value. The subordinated debentures must be redeemed no later than 2035.

The Corporation is not considered the primary beneficiary of these trusts, therefore the trusts are not consolidated in the Corporations' financial statements but rather the subordinated debentures are shown as a liability.

In the normal course of the interest rate risk management processes, management identified a possible risk to its interest rate risk profile that exposed the Corporation to a possible rise in funding costs. Specifically, during management's review of its Trust Preferred ("Trups") facilities referred to above, it noted that the interest rate currently maintains a floating rate based upon LIBOR. Management determined that the continuation of the Trups facilities at a floating rate may adversely affect the Corporation's net interest margin in a possible rising rate environment, exposing the Corporation to increased interest rate costs.

In the second quarter of 2013, the Corporation entered into an interest rate cap with Wells Fargo. An interest-rate cap is an over-the-counter derivative that protects the holder from rises in interest rates by making a payment to the holder when an underlying interest rate (the "index" interest rate) exceeds a specified strike rate (the "cap rate"). The interest rate cap is intended to effectively fix the maximum interest rate paid on the Corporation's trust preferred securities.

The interest rate cap has a notional amount of $12,000 and expires on June 15, 2020. During the term of the interest rate cap the Corporation will receive quarterly payments from Wells Fargo, calculated as the excess (if any) of LIBOR over the strike rate (2.00%). As of December 31, 2016 and 2015, respectively, the fair value of the interest rate cap was $142 and $191 which is included in other assets on the consolidated balance sheets.

In the third quarter of 2016, the Corporation entered into an $8,000 line of credit secured by the Corporation's investment in the Bank. This instrument has the option to be fixed or variable rate at the time of each draw and matures annually with any individual draw having a maturity of no more than 3 years. The fixed rate option would be priced at the time of draw and the variable rate spreads are 225 basis points over 1 month LIBOR and 50 basis points below Prime. There is $1,000 outstanding on the line at December 31, 2016 at a prime based variable rate of 3.00%.

## 11. INCOME TAXES

The provision for income taxes reflected in the consolidated statements of income for the years ended December 31 consists of the following:

| (000s omitted) | 2016 | 2015 |
|---|---|---|
| Current expense | $ 997 | $ 221 |
| Deferred expense | 1,296 | 2,186 |
| **Income tax expense** | **$ 2,293** | **$ 2,407** |

Income tax expense for continuing operations was less than the amount computed by applying the statutory federal income tax rate to income before income taxes. The reasons for the difference are as follows:

| (000s omitted) | 2016 | 2015 |
|---|---|---|
| Income tax at statutory rate | $ 2,290 | $ 2,414 |
| Tax exempt status | (68) | (59) |
| Other | 71 | 52 |
| **Income tax expense** | **$ 2,293** | **$ 2,407** |

The net deferred tax asset recorded includes the following amounts of deferred tax assets and liabilities:

| (000s omitted) | 2016 | 2015 |
|---|---|---|
| **Deferred tax assets** | | |
| Allowance for loan losses | $ 796 | $ 1,192 |
| Alternative minimum tax credit | 751 | 532 |
| Compensation | 330 | 254 |
| Net operating loss carryforwards | - | 311 |
| Non-accrual interest | 37 | 20 |
| Acquired loans | 1,797 | - |
| Other comprehensive income tax adjustments | 78 | 71 |
| Other | 529 | 228 |
| Total deferred tax assets | 4,318 | 2,608 |
| **Deferred tax liabilities** | | |
| Depreciation | $ (977) | $ (714) |
| Mortgage servicing rights | (818) | (498) |
| Core deposit intangible | (741) | - |
| Other | (171) | (35) |
| Total deferred tax liabilities | (2,707) | (1,247) |
| **Net deferred taxes** | **$ 1,611** | **$ 1,361** |

The deferred tax assets will continue to be analyzed at each reporting period for changes affecting realizability and a valuation allowance may be recorded in future periods accordingly. The ultimate realization of these deferred tax assets is primarily dependent on the generation of future taxable income during the periods in which those temporary differences become deductible. Changes in existing tax laws could also affect actual tax results and the valuation of deferred tax assets over time. The accounting for deferred taxes is based on an estimate of future results. Differences between anticipated and actual outcomes of these future tax consequences could have an impact on the Corporation's consolidated statement of income and balance sheet.

The Corporation concluded that there are no significant uncertain tax positions requiring recognition in the Corporation's consolidated financial statements based on the evaluation performed for the years 2013 through 2016, the years, which remain subject to examination by major tax jurisdictions as of December 31, 2016. The Corporation does not expect the total amount of unrecognized tax benefits ("UTB") (e.g. tax deductions, exclusions, or credits claimed or expected to be claimed) to significantly change in the next 12 months.

## 12. BENEFIT PLANS

The Corporation has a noncontributory discretionary employee stock ownership plan covering substantially all of its employees. It is a requirement of the plan to invest principally in the Corporation's common stock. No contributions were made to the Plan in 2016 and 2015.

The Corporation has also established a 401(k) Plan in which 100% of the employees' contribution can be matched up to 3% of their gross pay and 50% can be matched on the next 2% of their gross pay with a discretionary contribution by the Corporation. Contributions to the plan were $215 and $195 in 2016 and 2015, respectively. The balances in these plans are included in other liabilities on the consolidated balance sheets.

The Corporation entered into Supplemental Executive Retirement Agreements ("SERP Agreements") with certain executives. The SERP Agreements are designed to encourage executives to remain long term employees of the Corporation, and to provide specified benefits to certain key executives who contribute materially to the continued growth, development and future business success of the Corporation. The retirement benefits are an unsecured obligation of the Corporation. At year end 2016 and 2015, the accumulated liability for these plans totaled $746 and $745, respectively, and are included in accrued interest payable and other liabilities on the accompanying consolidated balance sheets.

The Corporation has also established other Non-Qualified Deferred Compensation arrangements for employees not covered under the SERP. The arrangements are designed to encourage certain officers to remain long-term employees of the Corporation and the Bank, and to provide the officers with supplemental retirement income. The Corporation made no contributions under these arrangements in 2016 or 2015.

## 13. COMMON STOCK PURCHASE AND OPTION PLANS

**Director and Employee Plans**

The Stock Purchase Plan permits directors and employees of the Corporation to purchase shares of common stock made available for purchase under the plan at the average fair market value of the shares over the most recent five days prior to the issuance date. The total number of shares issuable under this plan is limited to 330,000 shares.

The Retainer Stock Plan allows directors to elect to receive shares of common stock in full or partial payment of the director's retainer fees and fees for attending meetings. The number of shares is determined by dividing the dollar amount of fees to be paid in shares by the market value of the stock on the first business day prior to the payment date.

The Executive Stock Bonus Plan permits the administrator of the plan to grant shares of the Corporation's common stock to eligible employees. Any executive or managerial level employee is eligible to receive grants under the plan. The Board of Directors administers the plan and the numbers of shares issued are at the sole discretion of the Board of Directors. No shares were granted under this plan during 2016 and 2015.

**Dividend Investment Plan**

The Automatic Dividend Reinvestment Plan ("DRIP") permits enrolled shareholders to automatically use dividends paid on common stock to purchase additional shares of the Corporation's common stock at the fair market value on the investment date. Any shareholder who is the beneficial or record owner of not more than 9.9% of the issued and outstanding shares of the Corporation's common stock is eligible to participate in the plan.

Pursuant to a separate agreement with a family who collectively holds more than 9.9% of the Corporation's stock on or prior to January 31 of each year beginning January 31, 1997, the Corporation is to advise the family, in a written notice, of the number of shares sold under the DRIP. Each family member will have the option, until February 28 of the same year, to purchase from the Corporation one-third of the total number of shares that would be sufficient to prevent the dilution to all family members as a group that result from the DRIP shares. The purchase price under this agreement is the fair market value on December 31 of the year immediately preceding the year in which the written notice is given. Similarly, a reverse agreement exists which allows the Corporation to redeem family shares to maintain the family ownership percentage in the event that stock repurchase activity more than offsets the shares available because of the DRIP.

The following summarizes shares issued under the various plans:

| | 2016 | 2015 |
|---|---|---|
| Dividend reinvestment plan | 22,263 | 6,211 |
| Director and employee stock purchase and retainer stock | 7,843 | 8,075 |
| Other issuance of stock | - | 731 |
| | 30,106 | 15,017 |

**Stock Option Plans**

The Nonemployee Director Stock Option Plan provides for granting options to nonemployee directors to purchase the Corporation's common stock. The purchase price of the shares is the estimated fair value at the date of the grant, and there is a three-year vesting period before options may be exercised. Options to acquire no more than 8,131 shares of stock may be granted under the plan in any calendar year and options to acquire not more than 73,967 shares in the aggregate may be outstanding at any one time. No options were granted in 2016 and 2015.

The Employee Stock Option Plan grants options to eligible employees to purchase the Corporation's common stock at or above, the fair market value of the stock at the date of the grant. Awards granted under this plan are limited to an aggregate of 86,936 shares. The administrator of the plan is a committee of directors. The administrator has the power to determine the number of options to be granted, the exercise price of the options and other terms of the options, subject to consistency with the terms of the plan. No options were granted in 2016 and 2015.

The fair value of each option award is estimated on the date of grant using a closed form option valuation (Black-Scholes) model. Expected volatilities are based on historical volatilities of the Corporation's common stock. The Corporation uses historical data to estimate option exercise and post-vesting termination behavior. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant. Shares that are issued upon option exercise come from authorized but unissued shares.

There was no stock option activity in 2016 or 2015. No options were outstanding at December 31, 2016 or 2015. As of December 31, 2016 and 2015, there was no unrecognized compensation cost related to non-vested stock options granted under the Plan.

The Corporation has issued a total of 35,000 stock appreciation rights ("SARs") to the executive management team, using a price of $2.00 per share. The terms of the SARs provide that any appreciation in stock price will be paid in cash on two fixed dates which were subject to certain performance conditions, which management determined were met during 2013. SAR payment dates vary by individual agreement and range from February 2014 through May 2017. Expense of $17 and $204 was recorded in 2016 and 2015, respectively, resulting in a total liability of $167 and $252 at December 31, 2016, and December 31, 2015, respectively. These balances are reflective of vesting through the years then ended and are recorded in accrued interest payable and other liabilities on the consolidated balance sheets. The liability will continue to be re-measured each reporting period with changes recorded on a prospective ratable basis in salaries and employee benefits expense as further vesting transpires over the remaining SAR terms. The SAR's vest immediately upon a change in ownership control.

## 14. FAIR VALUE

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values.

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing and asset or liability.

**Securities Available for Sale**
The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). The remaining fair values of securities (Level 3 inputs) are based on the reporting entity's own assumptions and basic knowledge of market conditions and individual investment performance. The Corporation reviews the performance of the securities that comprise level 3 on a quarterly basis.

**Interest Rate Cap**
Substantially all of the derivative instruments held by the Corporation for risk management purposes are traded in over-the-counter markets where quoted market prices are not readily available. For those derivatives, the Corporation measures fair value using models that use primarily market observable inputs, such as yield curves and option volatilities, and include the value associated with counterparty credit risk. As such, the Corporation classifies those derivative instruments as Level 2.

**Impaired Loans**
The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

**Other Real Estate Owned**
Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate owned are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available, which results in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

**Goodwill**
Goodwill is subject to impairment testing on an annual basis. The assessment of goodwill for impairment requires a significant degree of judgement. In the event the assessment indicates that it is more-likely-than-not that the fair value is less than the carrying value, the asset is considered impaired and recorded at fair value. Goodwill that is impaired and subject to nonrecurring fair value measurements is a Level 3 valuation. At December 31, 2016, no goodwill was impaired.

**Core Deposit Intangible**
The core deposit intangible is recorded at fair value when initially recorded. Subsequently, core deposit intangible assets are amortized primarily on an accelerated basis over a 7 year period and are subject to impairment testing whenever events or changes in circumstances indicate that the carrying amount exceeds the fair value of the asset. If core deposit intangible asset impairment is identified, the Corporation classifies impaired core deposit intangible assets subject to nonrecurring fair value measurements as Level 3 valuations. At December 31, 2016, there was no impairment identified for core deposit intangible assets.

**Mortgage Servicing Rights**
MSR’s originated by the Corporation and those acquired in acquisitions are accounted for under the amortization method. The fair value of these MSR’s is initially estimated using a model that calculates the net present value of estimated future cash flows using various assumptions, including prepayment speeds, the discount rate and servicing costs. If the valuation model reflects a value less than the carrying value, MSR’s are adjusted to fair value, as determined by the model, through a valuation allowance. The Corporation classifies the MSR’s subject to nonrecurring fair value measurements as Level 3 valuations. At December 31, 2016 and 2015, there was no impairment identified for MSR’s.

**Assets Measured on a Recurring Basis**

Assets measured at fair value on a recurring basis are summarized below:

| 2016 (000s omitted) | Total | Fair Value Measurements Using: Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| **Available-for-sale securities** | | | | |
| U.S. government and federal agency | $ 37,414 | $ 13,531 | $ 23,883 | $ - |
| State and municipal | 15,923 | - | 15,923 | - |
| Mortgage backed residential | 6,270 | - | 6,270 | - |
| Certificates of deposit | 4,460 | - | 4,460 | - |
| Collateralized mortgage obligations – agencies | 3,194 | - | 3,194 | - |
| Equity securities | 1,311 | - | 988 | 323 |
| | $ 68,572 | $ 13,531 | $ 54,718 | $ 323 |
| **Interest rate cap** | $ 142 | $ - | $ 142 | $ - |

| 2015 (000s omitted) | Total | Fair Value Measurements Using: Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| **Available-for-sale securities** | | | | |
| U.S. government and federal agency | $ 2,983 | $ - | $ 2,983 | $ - |
| State and municipal | 5,683 | - | 5,683 | - |
| Mortgage backed residential | 7,894 | - | 7,894 | - |
| Collateralized mortgage obligations – agencies | 5,563 | - | 5,563 | - |
| Equity securities | 1,409 | - | 1,018 | 391 |
| | $ 23,532 | $ - | $ 23,141 | $ 391 |
| **Interest rate cap** | $ 191 | $ - | $ 191 | $ - |

The table below presents a reconciliation and income statement classification of gains and losses for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3).

| (000s omitted) | Equity Securities 2016 | Equity Securities 2015 |
|---|---|---|
| Beginning balance, January 1 | $ 391 | $ 387 |
| Included in net income | - | - |
| Included in other comprehensive income | (68) | 4 |
| **Ending balance, December 31** | **$ 323** | **$ 391** |

**Assets Measured on a Non-Recurring Basis**
Assets measured at fair value on a non-recurring basis are summarized below:

| 2016 (000s omitted) | Total | Fair Value Measurements Using: Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| **Impaired loans** | | | | |
| Commercial | $ 12 | $ - | $ - | $ 12 |
| Commercial real estate | 1,551 | - | - | 1,551 |
| Residential real estate | 208 | - | - | 208 |
| Installment | - | - | - | - |
| Home equity | - | - | - | - |
| **Total impaired loans** | **$ 1,771** | **$ -** | **$ -** | **$ 1,771** |

| 2015<br>(000s omitted) | Fair Value Measurements Using<br>Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| **Impaired loans** | | | | |
| Commercial | $ 16 | $ - | $ - | $ 16 |
| Commercial real estate | 1,736 | - | - | 1,736 |
| Residential real estate | 281 | - | - | 281 |
| Installment | - | - | - | - |
| Home equity | 21 | - | - | 21 |
| **Total impaired loans** | **$ 2,054** | **$ -** | **$ -** | **$ 2,054** |

The following represent impairment charges recognized during the year:

Impaired loans that are measured for impairment using the fair value of the collateral had a carrying amount of $2,055, with a valuation allowance of $284 at December 31, 2016. Impaired loans that are measured for impairment using the fair value of the collateral had a carrying amount of $2,251, with a valuation allowance of $197 at December 31, 2015.

Other real estate owned which is measured at the lower of carrying value or fair value less costs to sell, had a net carrying amount of $250, none of which was at fair value at December 31, 2016, as no write-downs were taken during 2016. Other real estate owned which is measured at the lower of carrying value or fair value less costs to sell, had a net carrying amount of $397, none of which was at fair value at December 31, 2015, as no write-downs were taken during 2015.

Qualitative information about level 3 fair value instruments is as follows as of December 31:

| 2016<br>(000s omitted)<br>Instrument | Level 3 Instruments<br>Fair Value | Valuation Technique | Unobservable Input | Weighted Average |
|---|---|---|---|---|
| Equity Securities | $ 323 | Market Comparable | Price to book ratio | 77.4% |
| Impaired Loans | $ 1,771 | Appraisal value - Real Estate | Discount applied to appraisal | 7.6% |

| 2015 (000s omitted) Instrument | Level 3 Instruments | | | |
|---|---|---|---|---|
| | Fair Value | Valuation Technique | Unobservable Input | Weighted Average |
| Equity Securities | $ 391 | Market Comparable | Price to book ratio | 77.0% |
| Impaired Loans | $ 2,054 | Appraisal value - Real Estate | Discount applied to appraisal | 10.3% |

Carrying amount and estimated fair value of financial instruments, not previously presented, at year end were as follows:

| (000s omitted) | 2016 | | 2015 | |
|---|---|---|---|---|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| **Assets** | | | | |
| Cash and cash equivalents | $ 78,313 | $ 78,313 | $ 19,425 | $ 19,425 |
| Securities held to maturity | 3,886 | 3,802 | 2,176 | 2,182 |
| Loans held for sale | 3,869 | 3,869 | 2,905 | 2,905 |
| Net loans (including impaired loans) | 512,924 | 507,616 | 375,150 | 370,863 |
| FHLB stock | 1,774 | 1,774 | 981 | 981 |
| Accrued interest receivable | 1,896 | 1,896 | 1,133 | 1,133 |
| **Liabilities** | | | | |
| Deposits | $ 603,367 | $ 603,088 | $ 375,971 | $ 375,971 |
| FHLB advances | 30,000 | 29,649 | 20,775 | 20,785 |
| Subordinated debentures | 14,000 | 14,000 | 14,000 | 13,980 |
| Senior debt | 1,000 | 1,000 | - | - |
| Accrued interest payable | 180 | 180 | 139 | 139 |

The following methods and assumptions were used by the Corporation in estimating its fair value disclosures for financial instruments:

**Cash and Cash Equivalents**
The carrying amounts reported in the consolidated balance sheets for cash and short-term instruments approximate their fair values.

**Securities Held to Maturity**
Fair values for securities held to maturity are based on similar information previously presented for securities available for sale.

**Loans Held for Sale**
The fair values of these loans are determined in the aggregate on the basis of existing forward commitments or fair values attributable to similar loans.

**FHLB Stock**
It was not practical to determine the fair value of FHLB stock due to restrictions placed on its transferability.

**Loans**
For variable rate loans that re-price frequently and with no significant change in credit risk, fair values are based on carrying values. The fair value of other loans is estimated using discounted cash flow analysis.

**Accrued Interest**
The carrying amount of accrued interest approximates its fair value.

**Off-Balance-Sheet Instruments**
The fair value of off-balance sheet items is not considered material.

**Deposits**
The fair values disclosed for demand deposits are, by definition, equal to the amount payable on demand at the reporting date. The carrying amounts for variable rate, fixed term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on similar certificates.

**FHLB Advances**
Rates currently available for FHLB advances with similar terms and remaining maturities are used to estimate the fair value of the existing obligations.

**Subordinated Debentures**
The estimated fair value of the existing subordinated debentures is calculated by comparing a current market rate for the instrument compared to the book rate. The difference between these rates computes the fair value.

**Senior Debt**
The estimated fair value of the existing senior is calculated by comparing a current market rate for the instrument compared to the book rate. The difference between these rates computes the fair value.

**Limitations**
Fair value estimates are made at a specific point in time, based on relevant market data and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Corporation's financial instruments, fair value estimates are based on management's judgments regarding future expected loss experience, current economic conditions, risk characteristics and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

## 15. ACCUMULATED OTHER COMPREHENSIVE INCOME

The following table presents a reconciliation of the changes in the components of accumulated other comprehensive income and details the components of other comprehensive (loss) income for the years ended December 31, 2016 and 2015, including the amount of income tax (benefit) expense allocated to each component of other comprehensive (loss) income:

| Year Ended December 31 | 2016 | 2015 |
|---|---|---|
| **Accumulated net unrealized gains on investment securities available-for-sale** | | |
| Balance at beginning of year, net of tax | $ 179 | $ 289 |
| Net unrealized holding gains (losses) arising during the year | (110) | 294 |
| Income taxes | 37 | (100) |
| **Net unrealized holding gains (losses) arising during the year, net of tax** | **(73)** | **194** |
| Less: Realized gains included in net income | - | (461) |
| Income taxes | - | 157 |
| **Reclassification adjustment for net securities gains included in net income, net of tax** | **-** | **(304)** |
| Change in net unrealized gains on investment securities available-for-sale, net of tax | (73) | (110) |
| **Balance at end of year, net of tax** | **106** | **179** |
| **Accumulated net losses on cash flow hedge:** | | |
| Balance at beginning of year, net of tax | (301) | (164) |
| Net cash flow hedge losses arising during the period | (49) | (207) |
| Income taxes | 17 | 70 |
| **Net cash flow hedge losses arising during the year, net of tax** | **(32)** | **(137)** |
| **Balance at end of year, net of tax** | **(333)** | **(301)** |
| **Accumulated other comprehensive income end of year, net of tax** | **$ (227)** | **$ (122)** |

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 16. REGULATORY MATTERS

The Corporation (on a consolidated basis) and its Bank subsidiary are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Corporation and the Bank. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation and the Bank must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance-sheet items that are calculated under regulatory accounting practices. The capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Failure to meet capital requirements can initiate regulatory action. The final rules related to the implementation of the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective for the Corporation on January 1, 2015, with full compliance of all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. The capital conservation buffer as of December 31, 2016 is 0.625%. The net unrealized gain or loss on available for sale securities is not included in computing regulatory capital. Capital amounts and ratios for December 31, 2014, are calculated using Basel I rules.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below). As of December 31, 2016 and 2015, the most recent notifications from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. Management believes, as of December 31, 2016 and 2015, that the Corporation and the Bank met all capital adequacy requirements to which they are subject. There are no conditions or events since the notifications that management believes have changed the Corporation and the Bank's category.

The Corporation's principal source of funds for dividend payments is dividends received from the Bank. Banking regulations limit the amount of dividends that may be paid without prior approval of regulatory agencies.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The tables below illustrate the regulatory capital amounts and ratios as of December 31, 2016 and 2015:

| 2016 (000s omitted) | Actual | | For Capital Adequacy Purposes | | To Be Well Capitalized | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total Capital (to Risk Weighed Assets) | | | | | | |
| The State Bank | $ 61,610 | 11.24% | $ 47,280 | 8.625% | $ 54,817 | 10.0% |
| Tier 1 (Core) Capital (to Risk Weighed Assets) | | | | | | |
| The State Bank | 58,759 | 10.72% | 36,316 | 6.625% | 43,854 | 8.0% |
| Common Tier 1 (CET1) | | | | | | |
| The State Bank | 58,759 | 10.72% | 28,094 | 5.125% | 35,631 | 6.5% |
| Tier 1 (Core) Capital (to Average Assets) | | | | | | |
| The State Bank | 58,759 | 11.69% | 20,114 | 4.000% | 25,142 | 5.0% |

| 2015 (000s omitted) | Actual | | For Capital Adequacy Purposes | | To Be Well Capitalized | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total Capital (to Risk Weighed Assets) | | | | | | |
| The State Bank | $ 46,185 | 11.9% | $ 31,023 | 8.0% | $ 38,779 | 10.0% |
| Tier 1 (Core) Capital (to Risk Weighed Assets) | | | | | | |
| The State Bank | 42,673 | 11.0% | 23,267 | 6.0% | 31,023 | 8.0% |
| Common Tier 1 (CET1) | | | | | | |
| The State Bank | 42,673 | 11.0% | 15,512 | 4.5% | 25,206 | 6.5% |
| Tier 1 (Core) Capital (to Average Assets) | | | | | | |
| The State Bank | 42,673 | 9.9% | 17,235 | 4.0% | 21,544 | 5.0% |

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 17. LOAN COMMITMENTS AND OTHER RELATED ACTIVITIES

**Off-balance-Sheet Risk**

Some financial instruments, such as loan commitments, credit lines, letters of credit, and overdraft protection, are issued to meet customer financing needs. These are agreements to provide credit or to support the credit of others, as long as conditions established in the contract are met, and usually have expiration dates. Commitments may expire without being used. Off-balance-sheet risk to credit loss exists up to the face amount of these instruments, although material losses are not anticipated. The same credit policies are used to make such commitments as are used for loans, including obtaining collateral at exercise of the commitment.

The contractual amount of financial instruments with off-balance-sheet risk was as follows at year-end:

| (000s omitted) | 2016 | 2015 |
|---|---|---|
| Commitments to make loans (at market rate) | $ 43,430 | $ 43,655 |
| Unused lines of credit and letters of credit | 69,283 | 53,503 |

Commitments to make loans are generally made for periods of 90 days or less.

## 18. CONTINGENCIES

**Litigation**

The Corporation is party to litigation arising during the normal course of business. In the opinion of management, based on consultation with legal counsel, the resolution of such litigation is not expected to have a material effect on the consolidated financial statements.

**Environmental Issues**

As a result of acquiring real estate from foreclosure proceedings, the Corporation is subject to potential claims and possible legal proceedings involving environmental matters. No such claims have been asserted as of December 31, 2016.